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TAGS: EINV ETRD EFIN
SUBJECT: Impact of Crisis: Ukrainians Suffering, But Not Rioting

¶1. (U) Summary. Real GDP contraction -- estimated to be 12%-15% for 2009 as a whole -- accumulating wage arrears, and a growing shadow economy have set Ukraine back in its economic development to the level of 2003, according to former Finance Minister Victor Pynzenyk. Despite increased hardship and growing poverty, the economic downturn has not given rise to widespread public unrest in Ukraine. A vast social safety system and the cushion provided by the shadow economy mitigate some of the social impact of the crisis, although lower wages and the resulting lower contributions to social security funds call into question the sustainability of the social security system. Political agendas in the run-up to the January Presidential make it likely that the underfunded social security system will remain in place at the expense of needed reform to facilitate economic recovery. End Summary.

Poverty Levels Rise

¶2. (U) Surveys by the Federation of Labor Unions (FPU) as well as by the Kyiv International Institute of Sociology (KIIS) conducted in June 2009 find that 81% to 90% of the population was affected by the general downturn in the economy. Ukraine's still-small middle class has been hit the hardest by the crisis, facing both wage cuts and a comparatively high level of outstanding bank loans. The industrial south and east have faced the largest decline in wages and increase in unemployment. The 2007 World Bank poverty study on Ukraine identified young families with children as having the highest risk of poverty. This finding remains valid and has been exacerbated in the current crisis, according to local think tanks. KIIS Director Volodymyr Paniotto points to the increases in poverty indicators, as more respondents this year cannot afford to buy enough clothing and food. 67% of Ukrainians have had to change their spending patterns due to the economic crisis, according to the survey of Ukraine's Sociology Institute. 60% of the survey respondents cut back on clothing, and 52% cut back on food. The number of respondents who identified themselves as middle class went down from 38% in 2008 to 28% in 2009 in favor of self-identification as members of the poor, according to the same survey.

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Direct Influence of the Banking Crisis is Limited
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¶3. (U) The direct influence of the banking crisis and abrupt decline in housing prices on the general population was limited due to the lack of depth in financial markets and comparatively low level of mortgage borrowing. While mortgage lending grew rapidly over recent years, its total volume reached only 5% of GDP in early 2008, much lower than the roughly 40-50% European average. Only about 17.7% of the population report that they have difficulties in paying their bank loans, and about 10% of the population has had difficulties withdrawing their deposits from distressed banks, according to the June Sociology Institute survey. The financial crisis had the largest direct influence on young households, making their dollar-denominated mortgages unsustainable. This category of the population was defined as having the highest poverty risk by the 2007 WB poverty survey on Ukraine, indicating their limited ability

to sustain their debt burden in the current crisis.

Higher Prices and Lower Incomes

¶4. (U) Growing prices are seen as the major consequence of the crisis by 80% of the population, according to both KIIS and Sociology Insitute surveys. Volodymyr Pantiotto, however, admits that the impact of price increases may be exaggerated by the public due to the high level of press attention. Still, the 60% hryvnia devaluation since October 2008 has made imports, which include such consumer goods as clothing and durables, more expensive, and was an important factor behind the 14.7% increase in consumer prices in June 2009 compared to June 2008.

¶5. (U) The public attributes lower incomes and wage delays to the crisis. 45% of KIIS survey respondents reported receiving lower incomes, and 14% reported delays in wage payments, with the highest frequency of these reports from the industrial eastern and southern regions. The end of 2008 saw accumulation of new wage arrears. While wage arrears have been a major problem since the 1990s, their level had stabilized by 2008 at about UAH 700 million. As the crisis erupted for Ukraine in November 2008, wage arrears more than doubled, reaching UAH 1.7 billion by January 1, 2009. Wage arrears averaged UAH 1.2 billion in the first half of 2009, peaking at about UAH 1.7 billion at the end of both Q1 and Q2. This level of wage arrears was last seen in 2004. The sharpest decline in wages was registered in the construction industry, followed by metallurgy and machine-building. Along with actual wage non-payment, many companies have resorted to cutting the total income earned by employees. There are many anecdotal reports that the amount of

wages paid on the shadow economy has decreased. Also, many industrial companies have stopped issuing bonuses and additional payments, which had equaled as much as 100% of basic wages prior to the crisis.

Unemployment Potential Risk Factor

¶6. (U) Unemployment, according to the ILO methodology, reached 9.5% of the labor force, up from 6.4% in 2008 and close to the EU average for 25 countries at 8.5% in the first quarter of 2009. In addition, according to Ukrstat, about 1.5 million employees had shortened working days or were on mandated leave as of June, bringing the total number of unemployed and those on shortened working days to 14% of the labor force. Unwillingness of companies to lay off their workers is partially explained by the experiences of industrial companies in the 1990s, when vast personnel cutbacks caused industries to lose large portions of their qualified labor force and made industrial recovery very difficult. The highest unemployment is expected in export-oriented sectors, such as chemical production and metallurgy, as well as construction, according to Labor Minister Lyudmila Denisova. Director of the Demographics Institute, Elena Libanova, told EconStaff that the GOU's effort to retain jobs may not be well targeted, as it mostly deals with the metallurgy sector. The December 2008 memorandum signed by the GOU with metallurgy companies requires them to maintain existing employment levels in exchange for GOU measures to limit gas and electricity prices for the plants. While export-oriented sectors are the largest foreign-currency earners, they are not the largest employers. Metallurgy, for example, employs 1.5 million of Ukraine's labor force of 21 million. GOU stimulus to the machine-building sector, which is a larger employer (employing close to 2 million out of Ukraine's 21 million laborers) would have greater impact, according to Libanova. According to the survey of the Sociology Institute, 88% of the population is concerned about losing their jobs, up from 54% in 2008; 74% (54% in 2008) are concerned about non-payment of wages.

Less Impact on Rural Population

¶7. (U) While the industrial eastern and southern regions were hit hard by the wage cuts at industrial enterprises, the impact on the rural population has so far been limited. Agriculture was the only sector which demonstrated growth in the first half of 2009 at 2.6%, y-o-y, as contrasted with a 31% decline in industrial production during the same period. Rural areas historically have lower-than-average incomes and very limited access to credit, which made them less exposed to financial crisis. The rural population also consumes fewer imported goods. A December 2008 regulation to restrict eligibility for unemployment benefits to those unemployed for 3 months or more could be detrimental to the rural population, as rural laborers traditionally receive unemployment benefits during the low agricultural season. However, according to Libanova, this regulation is not enforced, mitigating the impact on the rural population for now.

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The Shadow Economy Cushioned the Crisis' Impact
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¶8. (U) Despite a roughly 20% GDP decline in the first half of the year, the real level of disposable incomes went down by only 12.9%, suggesting the shadow economy provides a cushion to the impact of the crisis. The shadow economy was estimated at 36% of GDP in the first quarter of 2009, 7% larger than the same period in 2008, according to the preliminary report of the Economy Ministry. Root causes of the shadow economy are generally accepted to be political instability and ineffective tax policies, and its growth can be partially attributed to an increase in so-called "survival activities," which include operating small retail trade businesses and growing vegetables on small private plots. In the mining region of Donetsk, an increase in the activities of illegal coal mines is likely. Recently a shadow steel mill with an annual turnover of UAH 30 million (about USD 3.5 million) was found in Donetsk, the local press reported. There is also anecdotal evidence that medium and small businesses switch to shadow payment of wages to cut costs, and use barter to avoid problems with the distressed banking system. The share of shadow wage payment has increased, but is still much lower than during the 1990s, according to Paniotto.

Unsustainable Social Transfer System

¶9. (U) The economic downturn and growing shadow economy puts pressure on the government's ability to sustain large social security payments. Currently social transfers equal almost 50% of total residential incomes in Ukraine. High levels of social

transfers also increase the general mood of dissatisfaction among the working population and act as a disincentive to finding employment for those collecting benefits. For instance, the subsidy a family receives for a newborn child reaches up to UAH 50 thousand (USD 6 thousand), which is equal to 2 years of the average wage in Ukraine. This dwarfs the wages earned by most of the population and leads workers to consider themselves to be poor rather than middle class, according to Libanova. Still, in the run-up to the presidential elections, political consensus on reform of the social protection system is lacking. For example, the Party of Regions, led by one of the top three presidential candidates, Victor Yanukovych, insists on raising wages and pensions already this year. The party proposes to raise the minimum pension to UAH 1300 (USD 162) from UAH 572 (USD 71); and minimum monthly wage to UAH 1500 (USD 188) from UAH 669 (USD 84). According to various calculations, the law would require an additional UAH 10 to 40 billion in budgetary financing. This has the potential to bust the budget and runs contrary to IMF program requirements. Still, the political appeal of raising social standards is such that the Party of Regions has chosen to block the Rada (parliament), demanding adoption of the bill before any other work could proceed. The Rada remains blocked.

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GOU Anti-Crisis Efforts Criticized for Lack of Coordination
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¶10. (U) Suffering from constant political discord, the GOU has not been able to come up with a coordinated package of anti-crisis measures. The range of memoranda signed by the GOU with enterprises representing steel and chemical producers was criticized as sporadic. The ILO representative in Ukraine, Vasyl Kostrytsja, told EconStaff of the agency's efforts to encourage use of social partnership institutions, such as a trilateral dialogue among the government, employers and labor unions to come up with anti-crisis measures. In particular, the agency wants to organize regular trilateral meetings to analyze the market situation, develop a safety net package to limit the impact of the crisis, and promote small and medium entrepreneurship. Such efforts have not had much success so far.

Comment

¶11. (U) Existing social outlays and a large shadow economy will continue to mitigate the real impact of Ukraine's economic downturn on the population in the short term. However, both constitute a drag on the government's budget and broader economic growth. Unfortunately, reform efforts will not be taken up seriously before the January presidential election, delaying Ukraine's ability to engineer a strong economic recovery once the global economy rebounds.